

# Tulsa Law Review

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Volume 31  
Issue 3 *Practitioner's Guide to the October 1994  
Supreme Court Term*

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Spring 1996

## Gustafson v. Alloyd Co.: The Wrong Decision, But It Is Still Business As Usual in the Securities Markets

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### Recommended Citation

Kimberly D. Krawiec, *Gustafson v. Alloyd Co.: The Wrong Decision, But It Is Still Business As Usual in the Securities Markets*, 31 Tulsa L. J. 509 (2013).

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## **GUSTAFSON v. ALLOYD CO.: THE WRONG DECISION, BUT IT IS STILL BUSINESS AS USUAL IN THE SECURITIES MARKETS\***

Kimberly D. Krawiec†

### **I. INTRODUCTION**

The national mood in America today can, I believe, accurately be described as distinctly deregulatory. This trend may have begun in federal securities law as early as 1976 with *Ernst & Ernst v. Hochfelder*,<sup>1</sup> but gained speed in the 1990s. The current deregulatory fever is clearly reflected in the Republican Contract with America,<sup>2</sup> in the securities reform bills passed this year by both the House and the

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\* Based on remarks delivered at the Conference, *Practitioner's Guide to the October 1994 Supreme Court Term*, at The University of Tulsa College of Law, November 17, 1995. The text has been slightly modified from the original transcript and footnotes have been added.

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1. 425 U.S. 185 (1976) (holding that plaintiffs in private actions must show that the defendant acted with scienter in order to succeed in a Rule 10b-5 claim). For a discussion of Rule 10b-5 and the scienter requirement see *infra* notes 64 and 65.

2. H.R. 10, 104th Cong., 1st Sess. (1995). The "Common Sense Legal Reform Act of 1995," introduced on January 4, 1995, was the legislative embodiment of that portion of the Republican Contract with America which addressed reform of the tort liability system. *Id.* Title I of the Bill related to product liability reform and Title II contained provisions relating to securities litigation reform. *Id.* The Bill would have instituted a strict "loser pays" or "English Rule" requiring the loser to pay the winner's legal fees in all private securities litigation, required actual knowledge (as opposed to mere recklessness) and actual reliance (*i.e.* elimination of the "fraud on the market" theory) in all Section 10(b) and Rule 10b-5 actions, and instituted proportionate liability, class action reforms, and other mechanisms intended to correct perceived abuses in private securities litigation. *Id.*

Senate,<sup>3</sup> and in a line of cases contracting liability for material misstatements in offering documents,<sup>4</sup> of which *Gustafson v. Alloyd Co.*<sup>5</sup> is only the most recent decision. Although these reform initiatives are, no doubt, driven in part by the perception of widespread abuses in private securities litigation, *Gustafson* also reflects a recurring theme of the present Supreme Court discussed by many of the other speakers today: a renewed concern for federalism principles. Because this decision can be justified by neither the language of the Securities Act of 1933<sup>6</sup> (the "Act") nor on considerations of controlling precedent, *Gustafson* can only reflect the Court's belief that an excessive number of plaintiffs who perceive themselves as wronged in a business transaction seek recourse through the federal securities laws, and that some of these plaintiffs should be forced to seek their remedy in state court under traditional contract or corporate law theories.

It has been said that the decisions produced in the 1994-95 Supreme Court Term in the area of corporate and business law are notable primarily for their unanimity and lack of controversy.<sup>7</sup> *Gustafson*, which held that Section 12(2) of the Act applies only to public offerings by issuers and an issuer's controlling shareholders,<sup>8</sup> is certainly the exception to that characterization. The controversial five to four decision is contrary to what had been the prevailing view among

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3. On March 8, 1995, the House of Representatives passed H.R. 1058, the "Securities Litigation Reform Act," by a vote of 325-99. *House Amends and Passes Legislation to Reform Private Securities Litigation*, 27 Sec. Reg. & L. Rep. (BNA) 392 (March 10, 1995) [hereinafter H.R. 1058]. On June 28, 1995, the Senate passed S. 240, the "Private Securities Litigation Reform Act of 1995," by a vote of 70-29. *Id.* Subsequent to the date of this symposium, a House-Senate conference committee approved on November 28, 1995, an amended H.R. 1058. *Conferees on Securities Litigation Approve Bill Despite Strong Opposition*, 27 Sec. Reg. & L. Rep. (BNA) 1831 (Dec. 1, 1995). H.R. 1058 was passed over President Clinton's veto by the Senate on December 22, 1995, by a vote of 68-30, and by the House on December 20, 1995, by a vote of 319-100. *Senate Overrides President's Veto; Securities Litigation Reform Bill Now Law*, 28 Sec. Reg. & L. Rep. (BNA) 3 (Jan. 5, 1996).

4. See, e.g., *Lampf v. Gilbertson*, 501 U.S. 350 (1991), *cert. denied*, 501 U.S. 1277 (1991) (holding that there is an absolute three-year statute of limitations on federal securities-fraud claims by private plaintiffs); *Plaut v. Spendthrift Farm, Inc.*, 115 S. Ct. 1447 (1995) (finding unconstitutional Section 27A(b) of the Securities Exchange Act of 1934, which required courts to reopen cases dismissed as time-barred after June 20, 1991, when *Lampf* was decided, but before the Act became law six months later); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994) (ruling that there is no aiding and abetting liability in private actions under Rule 10b-5).

5. 115 S. Ct. 1061 (1995).

6. 15 U.S.C. §§ 77a-77bbbb (1994).

7. Robin S. Conrad, *Business Docket Brings Justices Into Unanimity*, THE NAT'L L. J., July, 31, 1995, at C6.

8. *Gustafson*, 115 S. Ct. at 1071.

commentators and practitioners for many years<sup>9</sup> and provoked vigorous dissents from both Justice Thomas and Justice Ginsburg. In addition, the division among the Justices is exceptional, with Thomas, Scalia, Ginsburg and Breyer joining in the dissent — an alliance not often seen in the Court's decisions.

Section 12(2) of the Act provides that any person who offers or sells a security, other than a security exempted under Section 3(a)(2) of the Act,<sup>10</sup> by means of a prospectus or oral communication which contains a misstatement or omission of a material fact, may be held liable to the purchaser thereof for rescission or damages, subject to an affirmative defense on the part of the defendant that the exercise of reasonable care would not have uncovered the misstatement or omission.<sup>11</sup> Although Section 12(2) would appear by its terms to apply to *any* purchase or sale of *any* security (other than Section 3(a)(2) exempted securities, as previously discussed), there had been, prior to *Gustafson*, some division among courts as to the Section's proper scope. The circuits were divided over the Section's application to secondary trading, but were unanimous in their belief that Section 12(2) applied to private placements. A few circuits, for example, along with several lower courts, had held that the application of Section 12(2) is limited to "initial offerings" of securities and does not apply to secondary trading.<sup>12</sup> Other circuits and lower courts, however, had reached the contrary conclusion.<sup>13</sup> All four circuits that had considered the

9. See, e.g., 3 LOUIS LOSS, SECURITIES REGULATION 1684 (1961) ("[Section 12(2)] imposes liability for rescission or damages upon anyone who offers or sells any security, *whether or not registered or exempt from registration*, by means of a material misstatement."); HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 14.05, at 14-46 to 14-73 (1991); 1 THOMAS L. HAZEN, LAW OF SECURITIES REGULATION § 7.5, at 301-05 (2d ed. 1990); 9 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4217-22 (3d ed. 1992); Therese H. Maynard, *Section 12(2) of the Securities Act of 1933: A Remedy for Fraudulent Postdistribution Trading?*, 20 SEC. REG. L. J. 152 (1992). But see, Elliott J. Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 BUS. LAW. 1 (1992).

10. 15 U.S.C. § 77c (1994). Securities exempted under Section 3(a)(2) of the Act include government securities, bank securities, and collective, common or single trust funds. *Id.*

11. 15 U.S.C. § 77l(2) (1994). This standard of reasonable care is substantially equivalent to the due diligence defense available to defendants under Section 11 of the Act. E.g., *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1228 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981); *Franklin Sav. Bank v. Levy*, 551 F.2d 521, 527 (2d Cir. 1977).

12. *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 684 (3d Cir. 1991), *cert. denied*, 502 U.S. 820 (1991); *First Union Discount Brokerage Serv., Inc. v. Milos*, 997 F.2d 835, 843 (11th Cir. 1993); *Comeau v. Rupp*, 810 F. Supp. 1127, 1154-55 (D. Kan. 1992); *Budget Rent A Car Sys., Inc. v. Hirsch*, 810 F. Supp. 1253, 1258 (S.D. Fla. 1992).

13. *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578, 582 (7th Cir. 1993); *Metromedia Co. v. Fugazy*, 983 F.2d 350, 360-61 (2d Cir. 1992), *cert. denied*, 113 S. Ct. 2445 (1993); *PPM Am., Inc. v. Marriott Corp.*, 820 F. Supp. 970, 978 (D. Md. 1993); *Hedden v. Marinelli*, 796 F. Supp. 432, 435 (N.D. Cal. 1992).

applicability of Section 12(2) to private offerings by issuers or an issuer's controlling shareholders had held that Section 12(2) applied to such sales.<sup>14</sup> The Supreme Court ruled otherwise, however, in *Gustafson*.

## II. *GUSTAFSON V. ALLOYD CO.*

*Gustafson* stemmed from the private sale by shareholders of substantially all of the outstanding stock of Alloyd Co., Inc. ("Alloyd").<sup>15</sup> Alloyd Holdings, Inc., a holding company formed for the purpose of effecting the sale, purchased the Alloyd stock on December 20, 1989, by means of a stock purchase contract.<sup>16</sup> No separate private offering memorandum or other disclosure document was provided to the purchasers.<sup>17</sup> Because Alloyd's practice, like that of many businesses, was to take inventory at year end, the parties were forced to rely on estimates of Alloyd's net worth in determining the purchase price.<sup>18</sup> The contract of sale included representations and warranties that the company's financial statements "present[ed] fairly . . . the Company's financial condition," and provisions were included in the contract of sale which provided for a post-closing adjustment of the purchase price in the event of an incorrect estimate.<sup>19</sup> After the year-end audit revealed that Alloyd's actual net worth was lower than the estimates relied upon by the parties in calculating the purchase price, the purchasers sued under Section 12(2) of the Act, seeking rescission of the entire purchase, rather than accepting a payment adjustment according to the contract.<sup>20</sup> The buyers alleged that the statements made by the selling shareholders regarding the financial condition of Alloyd were inaccurate, thus rendering the representations and warranties in the contract false and misleading.<sup>21</sup> The buyers further alleged that the contract was a "prospectus" as contemplated by Section 12(2) of the Act, thus giving rise to liability for any material misstatements.<sup>22</sup>

14. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1082 (1995) (Ginsburg, J., dissenting). See *Pacific Dunlop*, 993 F.2d at 587; *Metromedia*, 983 F.2d at 360-61; *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990); *Adalman v. Baker, Watts & Co.*, 807 F.2d 359, 364-65 (4th Cir. 1986); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973), *cert. denied*, 415 U.S. 977 (1974).

15. *Gustafson*, 115 S. Ct. at 1064.

16. *Id.* at 1064-65.

17. See *id.* at 1065-66.

18. See *id.* at 1065.

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

In ruling that the purchase contract was not a “prospectus,” the Court examined both the general structure of the Act and three specific sections relating to the term “prospectus”: Section 10, which sets forth the information which must be contained in a prospectus;<sup>23</sup> Section 12, which imposes liability based on material misstatements or omissions in a prospectus;<sup>24</sup> and Section 2(10), which defines the term “prospectus.”<sup>25</sup> In interpreting the term “prospectus,” the Court emphasized that the term should be construed consistently throughout the Act.<sup>26</sup>

Beginning its analysis with Section 10, the Court noted that the term “prospectus” as used in Section 10 is limited to documents that must include the information contained in a registration statement.<sup>27</sup> Because the purchase agreement in question did not, and was not required to, contain the information contained in a registration statement, the Court reasoned that it could not be a prospectus under Section 10.<sup>28</sup> The Court then noted that, in general, only public offerings of securities by an issuer or an issuer’s controlling shareholders require the preparation and filing of a registration statement.<sup>29</sup> It must follow, therefore, that a prospectus under Section 10 is confined to documents employed in connection with public offerings by an issuer or its controlling shareholders.<sup>30</sup> Reasoning that “identical words used in different parts of the same act are intended to have the same meaning,” the Court then held that if the contract under consideration was not a prospectus for purposes of Section 10, it could not be a prospectus for purposes of Section 12 either.<sup>31</sup>

Turning next to the general structure of the Act, the Court noted that the primary purpose of the Act was to create registration and disclosure obligations in connection with public offerings.<sup>32</sup> It is thus much more reasonable, the Court argued, to interpret the liability provisions of the Act, including Section 12(2), as providing remedies for violations of obligations imposed by the Act<sup>33</sup> — *i.e.* obligations in

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23. 15 U.S.C. § 77j (1994).

24. 15 U.S.C. § 77l (1994).

25. 15 U.S.C. § 77b(10) (1994).

26. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1066 (1995).

27. *Id.* Section 10 specifies that “a prospectus . . . shall contain the information contained in the registration statement.” 15 U.S.C. § 77j(a)(1) (1994).

28. *Gustafson*, 115 S. Ct. at 1067.

29. *Id.*

30. *Id.*

31. *Id.* (quoting *Department of Revenue v. ACF Indus., Inc.*, 114 S. Ct. 843, 845 (1994)).

32. *Id.* at 1068.

33. *Id.*

connection with public offerings. As support, the Court noted that Sections 11 and 12(1), the "statutory neighbors of Section 12(2)," afford remedies for violations of these obligations.<sup>34</sup>

Concluding its analysis, the Court turned to Section 2(10) of the Act, the definitional section, which defines the term "prospectus" to include "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security."<sup>35</sup> Rejecting Alloyd's argument that inclusion of the words "communication, written or by radio or television," meant that any written communication offering a security for sale was a prospectus,<sup>36</sup> the Court noted that the words "prospectus, notice, circular, advertisement, or letter" all refer to documents of widespread dissemination.<sup>37</sup> Similarly, the list included communications by radio or television, but not face-to-face or telephone communications.<sup>38</sup> The term "communication" as used in the list, therefore, must refer to a public communication.<sup>39</sup> In other words, the term "written communication" must be read in context to refer to writings that are similar to the terms "notice, circular, [and] advertisement"<sup>40</sup> — *i.e.* written communications to the public at large such as those used in a public offering.

### III. ANALYSIS

The *Gustafson* decision violates nearly every rule of statutory construction and is contrary to sixty years of jurisprudence concerning which communications constitute a prospectus. A standard rule of statutory construction is that when construing a legislative term, courts usually start with the definitional section, moving on to other sources only when the statutory definition is unclear or ambiguous.<sup>41</sup> The Court ignored this rule and instead turned first to an examination of Section 10, a substantive provision which was not even at issue in *Gustafson*.<sup>42</sup> The Court correctly noted that Section 10 gives a narrow meaning to the word prospectus as the term is used *in that section*.<sup>43</sup>

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34. *Id.*

35. 15 U.S.C. § 77b(10) (1994).

36. *Gustafson*, 115 S. Ct. at 1069.

37. *Id.* at 1070.

38. *Id.*

39. *Id.*

40. *Id.* at 1069-70.

41. See *id.* at 1079 (Thomas, J., dissenting); *id.* at 1080 (Ginsburg, J., dissenting).

42. *Id.* at 1080 (Ginsburg, J., dissenting).

43. *Id.*

But Section 2(10), the definitional section, contains a very broad definition of the term prospectus which is to be used throughout the Act *unless the context otherwise requires*.<sup>44</sup> Clearly, the context of Section 10 requires a different interpretation of the word prospectus. The context of Section 12(2), however, does not.<sup>45</sup> As Justice Ginsburg persuasively noted in her dissent, the majority reasoned backward: rather than consulting Section 2(10) to arrive at a definition of prospectus which will then be applied to the substantive provisions, including Sections 10 and 12, unless the context otherwise requires, the Court read into the literally and logically prior definitional section, Section 2(10), the meaning prospectus has in Section 10.<sup>46</sup>

Although the Court is correct in its contention that the same word used in different parts of a statute is generally considered to have the same meaning throughout, this presumption is not set in stone and is overcome when Congress clearly intended otherwise, as it did in drafting the Act.<sup>47</sup> As Justice Thomas pointed out in his dissent, the Court ignored one item in Section 2(10)'s list of documents that constitute a prospectus: any document that "confirms the sale of any security."<sup>48</sup> Congress obviously did not intend that every confirmation slip contain the information required in a Section 10 prospectus.<sup>49</sup> The Act, therefore, uses the term "prospectus" in two different ways.<sup>50</sup> Thomas further pointed out that the dual use of the word "prospectus" in Section 2(10) itself clearly indicates that Congress was using the term in two different ways: as a term of art meaning a document accompanying a public offering for purposes of Section 10, and

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44. See 15 U.S.C. § 77(b) (1994).

45. See *Gustafson*, 115 S. Ct. at 1076 (Thomas, J., dissenting).

46. *Id.* at 1080 (Ginsburg, J., dissenting). See also *id.* at 1076 (Thomas, J., dissenting) ("The majority transforms § 10 into the tail that wags the 1933 Act dog.").

47. *Id.* at 1076 (Thomas, J., dissenting); *id.* at 1080 (Ginsburg, J., dissenting).

Undoubtedly, there is a natural presumption that identical words used in different parts of the same act are intended to have the same meaning . . . . But the presumption is not rigid and readily yields whenever there is such variation in the connection in which the words are used as reasonably to warrant the conclusion that they were employed in different parts of the act with different intent . . . .

*Nations Bank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 115 S. Ct. 810, 816 (1995).

48. *Gustafson*, 115 S. Ct. at 1076 (Thomas, J., dissenting).

49. See *id.*

50. *Id.* Justice Ginsburg also notes that Congress itself, in enacting the Investment Company Act of 1940, explicitly recognized that the Act uses "prospectus" in two different senses: "'Prospectus' as used in [§ 22 of the Investment Company Act], means a written prospectus intended to meet the requirements of section 10(a) of the Securities Act of 1933 . . . and currently in use. As used elsewhere, 'prospectus' means a prospectus as defined in the Securities Act of 1933." *Id.* at 1080-81 (Ginsburg, J., dissenting) (quoting 15 U.S.C. § 80a-2(a)(31) (1994)) (alteration in original).



as a much broader term in Section 2(10).<sup>51</sup> Analyzed thus, the double use of the term "prospectus" in Section 2(10) seems logical. For purposes of the Act, unless the context otherwise requires, "prospectus" means not only those documents which are commonly known as a prospectus (*i.e.* those used in public offerings which contain the information required by Section 10), but also other letters, communications, and advertisements which offer a security for sale that are not normally thought of as a prospectus.

Also, both Ginsburg and Thomas note in their dissents that if Congress had intended Section 12(2) to apply only to public offerings by issuers and an issuer's controlling shareholders, it would have clearly stated such a limitation.<sup>52</sup> For example, Section 4(1),<sup>53</sup> which exempts transactions by any person other than an issuer, dealer, or underwriter, and Section 4(2),<sup>54</sup> which exempts transactions by an issuer not involving any public offering, make clear that Congress knew how to differentiate issuer public offerings from private placements and secondary sales.<sup>55</sup> Section 12(2)'s explicit exemption only for Section 3(a)(2) securities further demonstrates that Congress knew how to exempt specific securities and transactions from a liability provision's scope if it so desired.<sup>56</sup>

Furthermore, an examination of the structure of the Act does not, as the Court suggests, lead to the inevitable conclusion that Section 12(2) applies only to initial public offerings. In fact the Court explicitly rejected this reasoning in 1979 when it held that Section 17 of the Act is not limited to initial offerings, despite the fact that initial offerings and not secondary trading are the primary concern of the Act.<sup>57</sup> In rejecting respondent's argument that Section 17(a) did not apply to his fraud because it took place in the "aftermarket" and not in an initial public offering, the Court held that the correct interpretation of Section 17 was made "abundantly clear . . . by the statutory language, which makes no distinctions between the two kinds of transactions."<sup>58</sup> This reasoning is equally applicable to Section 12(2).<sup>59</sup>

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51. *Id.* at 1076 (Thomas, J., dissenting).

52. *Id.* at 1076-77 (Thomas, J., dissenting); *id.* at 1081 (Ginsburg, J., dissenting).

53. 15 U.S.C. § 77d(1) (1994).

54. 15 U.S.C. § 77d(2) (1994).

55. *See Gustafson*, 115 S. Ct. at 1077 (Thomas, J., dissenting).

56. *Id.*

57. *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979).

58. *Id.* at 778.

59. *See Gustafson*, 115 S. Ct. at 1077-78 (Thomas, J., dissenting); *id.* at 1081 (Ginsburg, J., dissenting).

In addition to misinterpreting congressional intent, the Court's decision in *Gustafson* is contrary to long-standing judicial and administrative understanding of the definition of "prospectus," particularly in connection with "gun jumping" jurisprudence under Section 5(b)(1) of the Act.<sup>60</sup> Following the *Gustafson* Court's analysis, one should be able to avoid violations of Section 5(b)(1) simply by refraining from the transmission of a prospectus (*i.e.* a document prepared in connection with a public offering which is required to meet the specifications of section 10) which does not contain all of the items contemplated by Section 10. Based on the broad definition of "prospectus" found in Section 2(10), however, it has always been the position of the Securities and Exchange Commission that the transmission of *any* written, radio or television communication which offers a security for sale is a violation of Section 5(b)(1).<sup>61</sup> Even those communications which do not explicitly offer a security for sale but are deemed to carry a danger of "conditioning the market," such as documents publicizing the issuer or the issuer's business, are prohibited as impermissible "prospectuses."<sup>62</sup> Eventually the Court will be called upon to rationalize its ruling in *Gustafson* with this body of decisions.

#### IV. FUTURE IMPLICATIONS

*Gustafson* limits the applicability of Section 12(2) to offerings of securities required to be registered under the Act and to public offerings of securities exempt from registration under Section 3 of the Act (other than paragraph (a)(2) thereof). Therefore, Section 12(2) liability will not attach to material misstatements and omissions made in connection with private placements and secondary market trades.<sup>63</sup>

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60. Section 5(b)(1) provides that it shall be unlawful "to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed . . . unless such prospectus meets the requirements of [Section 10]." 15 U.S.C. 77e(b)(1) (1994). The stage of registration covered by Section 5(b)(1) is referred to as the "Waiting Period" — that period after filing but prior to the effectiveness of a registration statement during which the right to offer securities is severely limited. Impermissible offers during the Waiting Period are thus termed "gun jumping."

61. Publication of Information Prior to or After the Effective Date of a Registration Statement, Securities Act Release No. 3844, Fed. Sec. L. Rep. (CCH) ¶ 3252 (Oct. 8, 1957). "Thus, . . . no written communication offering a security may be transmitted through the mails or in interstate commerce other than a prospectus authorized or permitted by the statute or relevant rules thereunder." *Id.* at ¶ 3258.

62. *Id.* at ¶ 3254. "Nor is it generally understood that the release of publicity and the publication of information between the filing date and the effective date of a registration statement may similarly raise a question whether the publicity is not in fact a selling effort by an illegal means; *i.e.*, other than by means of the statutory prospectus." *Id.*

63. See *Gustafson*, 115 S. Ct. at 1072-73.

The question now becomes: what does this mean for you as practicing attorneys? The implications of *Gustafson* seem particularly important in connection with private placements. Prior to *Gustafson*, we, as practitioners, had all assumed that Section 12(2) applied to private placements by an issuer or an issuer's controlling shareholders. As a result, private placements have been conducted as if Section 12(2) applied, with due diligence procedures in private placements being substantially consistent with those in a public offering. After *Gustafson*, is there no recourse for those who purchased a security in a private placement on the basis of fraudulent representations in an offering document? Should we now advise our clients to no longer waste the time and money expended in investigating the accuracy and completeness of private offering materials? The answer is: absolutely not. There are too many other legal and practical considerations which counsel against a radical change in conduct.

For example, liability for these transactions may still exist under Rule 10b-5.<sup>64</sup> Although it is more difficult for a plaintiff to prevail under Rule 10b-5 than under Section 12(2) due to the plaintiff's burden in a Rule 10b-5 action to prove reliance and scienter,<sup>65</sup> this additional hurdle is less significant in developing a policy regarding disclosure and investigation in unregistered transactions than it may first appear. The huge expenses which accompany discovery and litigation of this type, coupled with the potential for astronomically high damages lead to an abnormally high settlement rate in securities class actions.<sup>66</sup> The goal of any good corporate planner, therefore, should

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64. 17 C.F.R. 240.10b-5 (1995). Rule 10b-5 provides in relevant part that it shall be unlawful for any person "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." *Id.*

65. Although the Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), specifically declined to address the issue of whether reckless conduct constitutes scienter for purposes of Rule 10b-5, *id.* at 193 n.12, those circuit courts which have addressed the issue have held that intentional or reckless conduct is sufficient to meet the scienter requirement. *See, e.g.,* *Van Dyke v. Coburn Enters., Inc.*, 873 F.2d 1094, 1100 (8th Cir. 1989) (adopting recklessness standard and noting that the Second, Third, Fifth, Seventh, Ninth, Eleventh and D.C. Circuits have adopted the recklessness standard); *Backman v. Polaroid Corp.*, 893 F.2d 1405, *rev'd on other grounds*, 910 F.2d 10 (1st Cir. 1990) (adopting recklessness standard and noting that all of the eight circuit courts which have considered the issue have adopted the recklessness standard). The duty is on the plaintiff in a Rule 10b-5 action to prove scienter. In contrast, Section 12(2) imposes a negligence standard which requires the defendant to show that the exercise of "reasonable care" would not have uncovered the misstatement or omission. In addition, plaintiffs in a Section 12(2) claim need not show reliance.

66. Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991). Professor Janet Cooper Alexander conducted a study of class action litigation brought in the Northern District of California based on high technology company offerings that occurred during the first six months of 1983. She found that virtually all

be to avoid an appearance in court to begin with, or, barring that, to ensure a likely dismissal on summary judgment before the lengthy and expensive discovery process begins. A court ruling on a summary judgment motion and presented with evidence sufficient to establish negligent conduct may be unwilling to conclude that a jury could not reasonably find recklessness.

In addition, those who offer or sell securities in an unregistered offering by means of a material misstatement or omission must still contend with Section 17(a).<sup>67</sup> Although most courts have declined to imply a private right of action for Section 17(a) violations,<sup>68</sup> the Securities and Exchange Commission often proceeds in enforcement actions under that section.

Also, we, as practitioners, should not forget that in formulating an investigation and disclosure policy in connection with unregistered offerings, bases of state law liability must not be overlooked. All states have enacted some form of state securities or "blue sky" laws, which are not preempted by federal law<sup>69</sup> and are not affected by *Gustafson*. Most of these laws are patterned after the Uniform Securities Act,<sup>70</sup> which contains language in its Section 410(a)(2) nearly identical to that of Section 12(2) of the Act.<sup>71</sup> It remains to be seen whether

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of the cases were settled, with plaintiffs collecting an average of approximately 25% of the face value of their claim. *Id.* at 500. This information seems to confirm what many have always suspected: not only are most securities class actions settled, but the settlement value appears to bear no relation to the probability of plaintiffs' success on the merits. *Id.*

67. 15 U.S.C. § 77q (1994). The Supreme Court specifically held in *United States v. Naftalin* that Section 17(a) is not limited to initial public distributions of Securities. 441 U.S. 768, 778 (1979). The language of Section 17(a) is nearly identical to that of Rule 10b-5, the only difference being that Section 17(a) applies only to fraud in connection with "the offer or sale of any securities" and does not extend to purchases of securities as does Rule 10b-5. *See id.* at 777-78. In spite of this similarity in language, courts have construed the two provisions differently. In particular, the Supreme Court has held that while scienter is a necessary element of a cause of action under Section 17(a)(1), it is not a necessary element under Section 17(a)(2) or (3). *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

68. THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* 364 (3d ed. 1996). Although the vast majority of courts deny a private remedy under Section 17(a), district courts in the Second Circuit have held that such a remedy does exist. *JAMES D. COX ET AL., SECURITIES REGULATION* 675-76 (1991).

69. 15 U.S.C. §§ 77r, 78bb(a) (1994).

70. UNIF. SECURITIES ACT, 7B U.L.A. 509 (1956). *See HAZEN, supra* note 68, at 389 n.3.

71. Section 410(a)(2) states that:

Any person who . . . offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent per year from the date of

state courts interpreting the state law provision will be influenced by the Supreme Court's ruling in *Gustafson*. Because Section 410(a)(2) avoids reference to the term "prospectus," however, many state courts may rule that the decision has no bearing on interpretation of the state statute.

Finally, we should remember that disappointed purchasers of unregistered securities may still bring an action for common law fraud. Sellers may thus continue to be liable for false or misleading statements and omissions regardless of the applicability of state or federal securities laws. Similarly, bases of contractual liability should be considered. It is common for private placement purchase contracts to contain representations and warranties by the issuer as to the absence of material misstatements and omissions in the selling materials.<sup>72</sup> If this warranty is breached, then contractual liability may be found.

## V. CONCLUSION

The Supreme Court in *Gustafson* ruled that Section 12(2) of the Securities Act applies only to initial public offerings of securities by an issuer or an issuer's controlling shareholders — a decision supported by neither the language of the statute itself nor by controlling precedent. As a result, Section 12(2) liability will no longer attach to material misstatements or omissions made in connection with private placements and secondary market trades. This result is contrary to long-standing scholarly and judicial understanding of Section 12(2) and eliminates the most broadly available and stringent federal basis for recovery by a private plaintiff in an unregistered offering. Nonetheless, the decision does not warrant a radical revision of disclosure and investigation policy in unregistered transactions due to the continued existence of other legal and practical considerations.

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payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security.

UNIF. SECURITIES ACT, 7B U.L.A. 509, 643 (1956).

72. In fact, the purchase contract at issue in *Gustafson* contained a similar representation. Article IV of the purchase agreement, entitled "Representations and Warranties of the Sellers," included the statement that the company's financial statements "present fairly . . . the Company's financial condition," and that "there ha[d] been no material adverse change in . . . [Alloyd's] financial condition." *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1065 (1995).